

**RECOGNITION OF CONTINGENT LIABILITIES ARISING
FROM LITIGATION: An Amendment of
SFFAS No. 5, *Accounting for Liabilities
of the Federal Government***

**Statement of Federal Financial Accounting Standards
Number 12**

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THE FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD

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The Board communicates its recommendations by publishing recommended accounting concepts and standards after considering the financial and budgetary information needs of congressional oversight groups, executive agencies, and other users of federal financial information. The Board also considers comments from the public on its proposed recommendations, which are published for comment as "exposure drafts." After considering oral and written comments, the standards may be recommended by the Board. The Board's sponsors then decide whether to adopt the recommendations. If adopted, the standard is published by the OMB and the General Accounting Office and become effective.

The following documents related to the establishment and mission of the Board are available from the FASAB:

- (1) the "Memorandum of Understanding among the General Accounting Office, the Department of the Treasury, and the Office of Management and Budget on Federal Government Accounting Standards and a Federal Accounting Standards Advisory Board"*
- (2) the "Mission Statement of the Federal Accounting Standards Advisory Board"*

EXECUTIVE SUMMARY

This recommended accounting standard amends Statement of Federal Financial Accounting Standards Number 5, *Accounting for Liabilities of the Federal Government* (SFFAS No. 5). It provides an exception to the contingent liability standard for recognizing loss contingencies on matters of pending or threatened litigation and unasserted claims.

For loss contingencies covered by the exception, a contingent liability would be recognized¹ when a future outflow or other sacrifice of resources is “likely to occur,” a past event or exchange transaction has occurred, and the future outflow or sacrifice of resources is measurable. Before the amendment, SFFAS No. 5 called for recognition when an outflow is “more likely than not.” In addition to recognition, disclosure² would be required for loss contingencies on matters of pending or threatened litigation and unasserted claims if it is at least reasonably possible that a loss or an additional loss may have been incurred. The amendment does not affect recognition of other types of contingencies.

¹ The term “recognize” means the formal recording or incorporating of an item into the financial statements of an entity as an asset, liability, revenue, expense, etc. See FASAB Consolidated Glossary.

² The term “disclosure” means the reporting of information in notes or narrative regarded as an integral part of the basic financial statement. See FASAB Consolidated Glossary.

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Introduction

PURPOSE

1. This Statement amends Statement of Federal Financial Accounting Standards Number 5 (SFFAS No. 5), *Accounting for Liabilities of the Federal Government*, to provide an exception to the contingent liability standard for matters of pending or threatened litigation and unasserted claims. The proposed amendment would affect accounting for contingencies under SFFAS No. 5 by inserting an exception to the definition of "probable" and to the recognition criteria in SFFAS No. 5 (see current paragraphs 33, 36, and 38 of that standard in Appendix C).

SCOPE

2. This standard applies to evaluations and accounting recognition and disclosure of the future outcome of litigation.

BACKGROUND

3. The Federal Accounting Standards Advisory Board (FASAB) was asked to clarify the application of the standard for recognizing loss contingencies for pending or threatened litigation and unasserted claims. SFFAS No. 5 provides the definition for "liability" and establishes specific standards for five liability categories, including contingencies.
4. SFFAS No. 5 defines a contingency as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss.³ SFFAS No. 5 requires a liability to be recognized for loss contingencies when a past event or exchange transaction makes a future outflow of resources probable and measurable.⁴ It defines "probable" as that which can reasonably be expected or believed to be more likely than not on the basis of available evidence or logic but which is neither certain nor proven.⁵
5. SFFAS No. 5 uses the same general framework for evaluating loss contingencies as Financial Accounting Standards Board (FASB) Statement of Financial

³ SFFAS No. 5, par. 35, and also in Appendix C.

⁴ SFFAS No.5, par. 36.

⁵ SFFAS No. 5, par. 33 and also see SFFAS No. 5's Glossary.

Accounting Standards No. 5, *Accounting for Contingencies* (SFAS No. 5). Contingencies can be "probable," "reasonably possible," or "remote;" and, based on that, are recognized on the balance sheet, disclosed in footnotes, or not mentioned in the financial statements, respectively. However, SFAS No. 5 defines "probable" as "likely to occur" instead of "more likely than not."⁶

6. Some auditors have expressed reservations about their ability under Statement of Auditing Standards 12 (SAS 12) to express an unqualified opinion on the entity's financial statements without a legal representation letter that refers to the SFFAS No. 5 standard. Lawyers have expressed serious objection to the definition of probable ("more likely than not") contained in SFFAS No. 5. They state that a lawyer's prediction of failure under the SFFAS No. 5 definition of "probable" ("more likely than not"), and the recording of a liability to reflect that judgment, could be used as an admission against interest, thereby jeopardizing the government's ability to fairly defend the public interest. Similarly, they further state that a lawyer's response to an auditor's request for information on matters where an unfavorable outcome is more likely than not could result in the disclosure of information protected by the lawyer-client privilege, disadvantaging the government in any dispute, and violating the American Bar Association's Code of Professional Responsibility.
7. The Board believes that this amendment clarifies the standard for contingencies involving pending or threatened litigation and unasserted claims and will facilitate communication among auditors, lawyers, those who prepare financial statements, and those who use the financial statements.

MATERIALITY

8. The provisions of this statement need not be applied to immaterial items.

EFFECTIVE DATE

9. This standard is effective for reports issued subsequent to the date of this statement for reporting periods beginning after September 30, 1997.

⁶ SFAS No. 5, par. 3.

Accounting Standard

10. Paragraph 33 of SFFAS No. 5 is amended by adding "with the exception of pending or threatened litigation and unasserted claims" at the end of the first sentence. Paragraph 33 is further amended by adding the following footnote to the first sentence:

The concept of probability is imprecise and difficult to apply with respect to most legal matters. The "more likely than not" phrase suggests greater precision than is attainable when assessing the outcome of matters in litigation.

Accordingly, in the context of assessing the outcome of matters of pending or threatened litigation and unasserted claims, and recognizing an associated liability, "probable" refers to that which is likely, not to that which is more likely than not. Note that the remaining two criteria for recognizing a liability--that is, a past event or exchange transaction has occurred and the future outflow or sacrifice of resources is measurable--also must be met before recognizing a contingent liability in matters involving litigation.

11. Other conforming changes to SFFAS No. 5 are:

The first bullet of paragraph 36 is changed as follows: "Probable: The future confirming event or events are more likely than not to occur, with the exception of pending or threatened litigation and unasserted claims. For pending or threatened litigation and unasserted claims, the future confirming event or events are likely to occur."

Paragraph 38 of SFFAS No. 5 is amended by replacing "more likely than not" in the second bullet with "likely."

Appendix A: Basis for Conclusions

12. In their capacity as legal counsel to federal agencies, lawyers should evaluate the outcome of matters of pending or threatened litigation and unasserted claims, and estimate any losses therefrom, in accordance with the American Bar Association's *Statement of Policy Regarding Lawyer's Responses to Auditors' Requests for Information*. Attorneys note that neither the outcome of litigation nor any loss resulting therefrom can be assessed "in any way that is comparable to a statistically or empirically determined concept of probability" (see *Auditor's Letter Handbook*, American Bar Association, page 18). The "more likely than not" phrase suggests greater precision than is attainable when assessing the outcome of matters in litigation.
13. Accordingly, in the context of such cases the standard refers simply to that which is "likely." In this context, therefore, "likely to occur" is used in federal accounting standards in the same way that it is used in Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, published by the Financial Accounting Standards Board in 1975.
14. The Board believes that this amendment will serve the objectives of financial reporting because it will facilitate communications among auditors, lawyers, those who prepare financial statements, and those who use the statements.
15. The Board published an exposure draft of this standard on October 30, 1998, and received thirty responses, six of which had no comment. Of the 24 who commented, 22 concurred with the proposed standard. (Two responses were positive but could not be characterized as concurrence.) No respondent objected to the amendment. Five respondents suggested broadening the scope of the amendment to apply "likely to occur" to all contingent liabilities.
16. Although some respondents suggested broadening the application, the Board concluded that the amendment should be limited to contingent liabilities resulting from litigation. Most respondents concurred with this approach. The Board plans additional research on this subject in 1999.
17. The Board has made minor changes to the proposal published as an exposure draft. Several respondents suggested minor changes in wording and/or notations in paragraphs 33 and 36 in addition to or instead of paragraph 38 to

clarify the amendment. The Board has adopted most of these suggestions.

18. The Board makes this recommendation with a vote of nine members approving issuance and no members opposing issuance.

Appendix B: Selected Section from Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*.

1. For the purposes of this Statement, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a "gain contingency") or loss (hereinafter a "loss contingency") to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.

* * *

3. When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable*, *reasonably possible*, and *remote* to identify three areas within that range, as follows:

- a. *Probable*. The future event or events are likely to occur.
- b. *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.
- c. *Remote*. The chance of the future event or events occurring is slight.

* * *

8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income if *both* of the following conditions are met:

- a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statement. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
- b. The amount of the loss can be reasonably estimated.

Appendix C: Selected Sections of Statement of Federal Financial Accounting Standards No. 5, *Accounting for Liabilities of the Federal Government* (footnotes omitted).

* * *

- 33 “Probable” refers to that which can reasonably be expected or is believed to be more likely than not on the basis of available evidence or logic. The probability of a future outflow or other sacrifice of resources is assessed on the basis of current facts and circumstances. These current facts and circumstances include the law that provides general authority for federal entity operations and specific budget authority to fund programs. If budget authority has not yet been provided, a future outflow or other sacrifice of resources might still meet the probability test if (1) it directly relates to ongoing entity operations and (2) it is the type for which budget authority is routinely provided. Therefore, the definition applies both to liabilities covered by budgetary resources and to liabilities not covered by budgetary resources.

* * *

CONTINGENCIES

- 35 A contingency is an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an entity. The uncertainty will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm a gain (i.e., acquisition of an asset or reduction of a liability) or a loss (i.e., loss or impairment of an asset or the incurrence of a liability).
- 36 This Statement does not deal with gain contingencies or measurement of contingencies that involve impairment of nonfinancial assets. When a loss contingency (i.e., contingent liability) exists, the likelihood that the future event or events will confirm the loss or the incidence of a liability can range from probable to remote. The probability classifications are as follows:
- Probable: The future confirming event or events are more likely than not to occur.
 - Reasonably possible: The chances of the future confirming event or events occurring is more than remote but less than probable.
 - Remote: The chance of the future event or events occurring is slight.

37 The following are some examples of loss contingencies:

- collectibility of receivables,
- pending or threatened litigation, and
- possible claims and assessments.

CRITERIA FOR RECOGNITION OF A CONTINGENT LIABILITY

38 A contingent liability should be recognized when all of these three conditions are met:

- A past event or exchange transaction has occurred (e.g., a federal entity has breached a contract with a nonfederal entity).
- A future outflow or other sacrifice of resources is probable (e.g., the nonfederal entity has filed a legal claim against a federal entity for breach of contract and the federal entity's management believes the claim is more likely than not to be settled in favor of the claimant).
- The future outflow of resources is measurable (e.g., the federal entity's management determines an estimated settlement amount).

39 The estimated liability may be a specific amount or a range of amounts. If some amount within the range is a better estimate than any other amount within the range, that amount is recognized. If no amount within the range is a better estimate than any other amount, the minimum amount in the range is recognized and the range and a description of the nature of the contingency should be disclosed.

CRITERIA FOR DISCLOSURE OF A CONTINGENT LIABILITY

40 A contingent liability should be disclosed if any of the conditions for liability recognition are not met and there is at least a reasonable possibility that a loss or an additional loss may have been incurred. "Disclosure" in this context refers to reporting information in notes regarded as an integral part of the basic financial information.

41 Disclosure should include the nature of the contingency and an estimate of the possible liability, an estimate of the range of the possible liability, or a statement that such an estimate cannot be made.

- 42 In some cases, contingencies may be identified but the degree of uncertainty is so great that no reporting (i.e., recognition or disclosure) is necessary in the general purpose federal financial reports. Specifically, contingencies classified as remote need not be reported in general purpose federal financial reports, though law may require such disclosures in special purpose reports. If information about remote contingencies or related to remote contingencies is included in general purpose federal financial reports (e.g., the total face amount of insurance and guarantees in force), it should be labeled in such a way to avoid the misleading inference that there is more than a remote chance of a loss of that amount.

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